No. 10908

In the United States Circuit Court of Appeals for the Ninth Circuit

LENORE S. ROBINETTE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

SAMUEL O. CLARK, Jr.,
Assistant Attorney General.
SEWALL KEY,
ROBERT N. ANDERSON,
LEONARD SARNER,
Special Assistants to the Attorney General.

INDEX

CITATIONS

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OPINION BELOW

The opinion of the Tax Court of the United States (R. 14–21) is not reported.

JURISDICTION

This case involves the income tax liability of Lenore S. Robinette for the period February 1, 1939, to December 31, 1939. Notice of deficiency was mailed on January 9, 1943 (R. 9), and the petition for redetermination was filed with the Tax Court on April 5, 1943 (R. 1), pursuant to Section 272 (a) of the Internal Revenue Code. The decision of the Tax Court was entered on April 27, 1944. (R. 22.) The motion for rehearing and reconsideration was filed on May 25, 1944 (R. 2, 22–26), and the order denying the mo-

tion entered on June 5, 1944 (R. 32–33). The petition for review was filed on August 30, 1944. (R. 34–41.) Venue was stipulated by agreement pursuant to Section 1141 (b) (2) of the Internal Revenue Code, and the jurisdiction of this Court rests upon Sections 1141–1142 of the Internal Revenue Code.

QUESTION PRESENTED

A parent corporation within the scope of Section 112 (b) (6) of the Revenue Act of 1936 completely liquidated a wholly owned subsidiary having earnings or profits accumulated after February 28, 1913. In 1939 the parent made a distribution to its shareholders. Was the distribution made from the parent's earnings or profits under Section 115 (a) and (h) of the Internal Revenue Code?

STATUTES AND REGULATIONS INVOLVED

These will be found in the Appendix, *infra.*

STATEMENT

The facts relevant for this appeal as found by the Tax Court may be summarized as follows:

During the year 1939 taxpayer owned 833⅓ shares of stock of the Metropolitan Properties Company, a corporation organized under the laws of the State of California on November 21, 1924. As a stockholder of that corporation she received in the period involved distributions from the corporation amounting to $7,916.60. Taxpayer returned as taxable income $2,047.63 of that amount, or 25.865%. The return was made upon advice from the corporation that of the total distribution to her $5,868.97 or 74.135%

was a distribution from capital and not from earnings, profits or surplus. (R. 14–15.)

Metropolitan was on December 24, 1936 the sole stockholder of the Cole-French Company. (R. 15.) On that day Cole-French, in complete liquidation, distributed all of its assets subject to liabilities to Metropolitan in exchange for all of its shares, which were then cancelled and the corporation forthwith dissolved. (R. 17.) Immediately prior to the liquidation Cole-French had earnings or profits accumulated after December, 1919, of at least $225,000. (R. 20, 42.)

The distribution by Cole-French to Metropolitan was in pursuance of the complete liquidation of a wholly owned subsidiary. By virtue of the provisions of Section 112 (b) (6) of the Revenue Act of 1936 no gain or loss to Metropolitan was recognized. (R. 18.) The fair market value of the assets less liabilities received by Metropolitan exceeded the adjusted basis of the stock of Cole-French in the hands of Metropolitan by not less than $200,000, but during 1939 the fair market value of those assets still retained by Metropolitan declined by more than $200,000. (R. 18.)

The Tax Court affirmed the determination of the Commissioner that upon the complete liquidation of Cole-French in 1936 the earnings or profits of that company should be included in determining whether the cash distributions by Metropolitan in 1939 were taxable in full as dividends paid out of its earnings or profits accumulated after February 28, 1913, under the doctrine of the *Sansome* case. (R. 19–21.) From this decision, taxpayer appeals.

SUMMARY OF ARGUMENT

The legislative history, regulations and express language of Section 115 (h) of the Internal Revenue Code clearly provide that the earnings or profits of a subsidiary corporation completely liquidated by its parent under Section 112 (b) (6) of the Revenue Acts of 1936, 1938 or the Internal Revenue Code retain their character as such in the hands of the parent and are available for the future distribution of taxable dividends. This controversy involves income tax liability for the last 11 months of 1939. The transaction giving rise to tax—the distribution by Metropolitan to taxpayer—took place in 1939 and was covered by the Internal Revenue Code. Hence, taxpayer's emphasis upon the applicability of the Revenue Act of 1936 and the result which allegedly would follow were it controlling is entirely misplaced. The distribution was thus made from Metropolitan's earnings or profits accumulated after February 28, 1913, and inherited at the time Cole-French was liquidated tax-free under Section 112 (b) (6) of the Revenue Act of 1936. Moreover, regardless of the character of the assets at the moment they passed from Cole-French to Metropolitan, Congress could change, assuming *arguendo* it was a change, the federal definition of a taxable dividend by altering its previous description of earnings or profits. At most this involves the retroactive application of rules for determining current taxable income which is entirely within the Congressional power.

But even if the Revenue Act of 1936 were applicable, the instant distribution would still be out of

Metropolitan's earnings or profits under Section 115 (h) of the Revenue Act of 1936 and the rule of the *Sansome* case. There are no essential differences between an isolated corporate liquidation of a subsidiary corporation and one connected with a reorganization, and the series of cases applying the *Sansome* doctrine involve many where the transferor corporation has been liquidated in connection with a reorganization. No gain or loss is recognized in both instances and there is present complete identity of the two corporations and continuity of the proprietary interest. The parent retains the earnings of the subsidiary and the earnings do not simply vanish after the liquidation. The rule in the *Sansome* case would always have been applied in a tax-free liquidation of a wholly owned subsidiary and its application should not be precluded by the enactment of Section 115 (h) of the Revenue Act of 1936 which was intended to give express legislative approval to the doctrine.

ARGUMENT

The distribution in 1939 was made from Metropolitan's earnings or profits accumulated after February 28, 1913, under Section 115 (a) and (h) of the Internal Revenue Code

The question in this case involves the source of the cash distribution made by Metropolitan Properties Corporation to taxpayer in 1939. It is the Government's main contention that Section 115 (h) of the Internal Revenue Code (Appendix, *infra*) specifically supplies the answer that the distribution was made out of the corporation's earnings or profits accumulated after February 28, 1913.

Since the agreed statement of facts implied that the distribution in 1939 was not a dividend unless Metropolitan were allocated the earnings or profits of its subsidiary Cole-French Company in the tax-free liquidation of 1936, it was first necessary to demonstrate to the Tax Court that prior to the liquidation, Cole-French actually did have earnings or profits from which dividends could be paid. Taxpayer on this appeal has not seen fit to attack this finding of the Tax Court in favor of the Government and concedes[1] (Br. 4) that immediately prior to its complete liquidation on December 24, 1936, Cole-French had undistributed accumulated earnings or profits in sufficient amounts to cover the entire distribution of Metropolitan in 1939. Thus the sole ground raised by taxpayer for

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[1] The reason is readily understood. In 1929, when Cole-French admittedly had earnings in excess of $225,000, the directors authorized a bookkeeping transfer from surplus to capital account to pay up the unpaid balance of the stock of the corporation which had not been fully paid for by the shareholders. This was essentially the equivalent of a stock dividend (*Michaels* v. *McLaughlin*, 20 F. 2d 959 (N. D. Cal.); *Teehan* v. *United States*, 25 F. 2d 884 (Mass.)), not taxable under the Revenue Act of 1928 (*Eisner* v. *Macomber*, 252 U. S. 189; *Helvering* v. *Griffiths*, 318 U. S. 371), and thus not capable of reducing earnings or profits available for future dividend distributions within the meaning of Section 115 (h) of the Internal Revenue Code (*Beretta* v. *Commissioner*, 141 F. 2d 452 (C. C. A. 5th), certiorari denied, October 9, 1944; *Van Norman Co.* v. *Welch*, 141 F. 2d 99 (C. C. A. 1st); *Century Electric Co.* v. *Commissioner*, 144 F. 2d 983 (C. C. A. 8th); *Chapman Price Steel Co.* v. *Commissioner* (C. C. A. 7th), decided December 15, 1944 (1944 P–H, par. 62,810); *Walker* v. *Hopkins*, 12 F. 2d 262 (C. C. A. 5th), certiorari denied, 271 U. S. 687). But see *Patty* v. *Helvering*, 98 F. 2d 717 (C. C. A. 2d); *Bedford* v. *Commissioner*, 144 F. 2d 272 (C. C. A. 2d), certiorari granted, January 8, 1945, relating to liquidating distributions.

attacking the decision of the Tax Court is that the earnings or profits did not retain their character as such in the hands of Metropolitan even though no gain or loss was recognized on the transaction.

We have only to look at the language of the applicable Revenue Act and regulation promulgated thereunder to see the weakness in taxpayer's position. This controversy involves income tax liability for the last 11 months of 1939. The controlling law is that contained in the Internal Revenue Code and the applicable section which specifically governs the problem in Section 115 (h). The provisions of this section are the same as those contained in the Revenue Act of 1938 and taxpayer concedes (Br. 7, 8, 24–25, 30) that this Act provides that after a tax-free liquidation under Section 112 (b) (6) the earnings or profits of the subsidiary retain their character in the hands of the parent and are available for the distribution of taxable dividends. Thus, whatever the reason [2] for the amendment of 1938 which added the words "or of property or money" to Section 115 (h) of the Revenue Act of 1936, c. 690, 49 Stat. 1698, the legislative history,[3] regulations,[4] and simple words of the statute [5]

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[2] The committee reports state it to be in the interest of added clarity. See fn. 3, *infra*.

[3] S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 779, 792) states:

"SECTION 115 (h). *Effect of Distributions on Earnings and Profits.*

"Under existing law, distributions of any property by a corporation which under the provisions of section 112 (b) or (c) are received by the shareholder without the recognition of gain to

(Footnotes [4] and [5] on p. 8)

show that from the taxable year 1938 on, any distribution by a parent corporation out of earnings or profits of its subsidiary liquidated prior to 1938 under Section 112 (b) (6) is a taxable dividend within the meaning of the federal statute. We have here a distribution in 1939. Hence, taxpayer's emphasis upon the application of the Revenue Act of 1936 and the result which allegedly would follow were it controlling is entirely misplaced. Regardless of the character of the assets at the moment they passed from Cole-French to Metropolitan in 1936 surely Congress can change, assuming *arguendo* it was a change, the federal definition of a taxable dividend by altering its previous description of earnings or profits. This raises no problem similar to that involved in *Helvering* v. *Credit*

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him (irrespective of what basis the property takes in the hands of such shareholder) are not regarded as being in any respect distributions of earnings or profits. Consequently, such earnings or profits remain unimpaired out of which taxable dividends may subsequently be declared either by the corporation making the distribution or by another corporation which, as to property acquired in an exchange described in section 112, takes in whole or in part the transferor's basis, so that the earnings or profits of the transferor corporation become in whole or in part the earnings or profits of such other corporation.

"In view of the fact that sections 112 (b) (6) and (7) permit the distribution of property (including money), in addition to stock or securities, without the recognition of gain to the distributee, appropriate changes are made in section 115 (h) of the House bill in the interest of added clarity."

[4] Article 115–11, Treasury Regulations 101, promulgated under the Revenue Act of 1938, is substantially identical with Regulations 103, Section 19.115–11, Appendix, *infra*.

[5] Section 115 (h) of the Revenue Act of 1938, c. 289, 52 Stat. 447, is substantially identical with Section 115 (h) of the Internal Revenue Code, Appendix, *infra*.

Alliance Co., 316 U. S. 107, where the Supreme Court held that an intent disclosed from the 1938 amendment did not affect the 1936 tax liability. Here the transaction giving rise to the tax—the distribution by Metropolitan to taxpayer—took place in 1939 and was covered by the Internal Revenue Code.

It is true that in a sense an example of retroactive application of rules for determining *current* taxable income may be involved. But this obviously cannot be successfully attacked. A prolific source of income tax controversy and litigation is the question of the basis upon which is to be reckoned the gain or loss from the sale or exchange of property and a major point of attack has been the freedom with which Congress has modified this basis of property in the hands of the same taxpayer. The reorganization sections serve to illustrate.[6] Assume a taxpayer acquires property after March 1, 1913, at a cost of $100,000. By 1923 the property has increased in value to $1,000,000. If sold in 1923, the basis to be subtracted from the selling price in order to determine gain or loss will be the cost of the property and the resulting taxable gain, $900,000. So the taxpayer forms a corporation and transfers the property to it in exchange for all its stock. The basis of the property to the corporation is then the fair market value of the property when acquired, or $1,000,000, and if it sells the property in 1923 no taxable gain will result.[7] The

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[6] The illustration is taken from Ballard, Retroactive Federal Taxation, 48 Harv. L. Rev. 592, 599 (1935).

[7] Nor would there have been any taxable gain on the exchange itself since under the Revenue Act of 1921, Section 202 (c) (3), no gain or loss was recognized on the transfer of property to a

Revenue Act of 1924 met this situation by providing that in the case of property acquired after December 31, 1920, by a controlled corporation, the basis of the property in the hands of the corporation would be the same as in the hands of the transferor. If the property is sold under this new provision even though it was acquired before the enactment, the basis will thus be $100,000 and the corporation will be taxable on a gain of $900,000. This Court has upheld this Congressional power to define current taxable income by changing the basis of property already in the hands of the taxpayer. *Osburn California Corp.* v. *Welch,* 39 F. 2d 41 (C. C. A. 9th), certiorari denied, 282 U. S. 850. See also *Newman, Saunders & Co.* v. *United States,* 36 F. 2d 1009 (C. Cls.), certiorari denied, 281 U. S. 760; *Lawler* v. *Commissioner,* 78 F. 2d 567 (C. C. A. 9th); *Martz* v. *Commissioner,* 82 F. 2d 110 (C. C. A. 9th). As was said in *Phipps* v. *Bowers,* 49 F. 2d 996, 998 (C. C. A. 2d), certiorari denied, 284 U. S. 641:

> The statute was valid and applicable to an earlier purchase and sale, as it was good prospectively. It but defines income for 1921, and taxes the income for that year. If it changed the rate and tax from what the taxpayer expected it to be in view of the earlier statute, it did no more than is always done when a taxing statute is changed.

Congress provided in the Internal Revenue Code that distributions received in 1939 having their source

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corporation by persons "who * * * immediately after the transfer are in control of such corporation."

in assets of subsidiaries liquidated tax-free at any time are from earnings or profits to the extent they so existed in the subsidiary. That at the time of the liquidation in 1936 Metropolitan might then have been able to make a nondividend distribution to taxpayer shows at most a change in definition entirely within the Congressional power.[8]

The foregoing analysis accepted taxpayer's assertion (Br. 21) that Section 115 (h) of the Revenue Act of 1936 represented a legislative attempt to preclude the applicability of the doctrine of *Sansome* v. *Commissioner,* 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, to tax-free liquidations under Section 112 (b) (6) (Appendix, *infra*) and that if the Revenue Act of 1936 were the controlling law, the distribution in 1939 by Metropolitan to taxpayer would not be out of Metropolitan's earnings or profits. But this as-

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[8] It should be observed that the decision of this Court in *Wheeler* v. *Commissioner*, 143 F. 2d 162, certiorari granted October 16, 1944, gives a further basis for taxing the distribution as a dividend. For if Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, may not be constitutionally applied to the instant case then, per *Wheeler*, the doctrine of *F. J. Young Corp.* v. *Commissioner*, 103 F. 2d 137 (C. C. A. 3d), and *W. F. Farish & Co.* v. *Commissioner*, 104 F. 2d 833 (C. C. A. 5th), applies to the 1936 tax-free liquidation. Metropolitan realized on the exchange $200,000 of earnings or profits, since the fair market value of the assets less liabilities received exceeded the adjusted basis of the stock of Cole-French in the hands of Metropolitan by not less than this amount. (R. 18.) This realized but unrecognized gain under the *Young* and allied cases may be the source of a dividend distribution. That the assets declined in value without being disposed of obviously does not reduce earnings. See 1 Mertens, Law of Federal Income Taxation, Sec. 9.49, and cases there cited.

sertion of taxpayer is without foundation in law. In substance taxpayer's argument comes down to the proposition that although there were earnings or profits prior to the liquidation, immediately thereafter they were gone. Neither the liquidated nor the parent corporation has them, despite the fact the corporate transfer of the earnings or profits resulting in no recognition of gain or loss to Metropolitan. This is an absurd result and wholly out of keeping with the Congressional approval of the doctrine of the *Sansome* case as shown in the committee reports to the Revenue Acts of 1936,[9] 1938[10] and 1940.[11] See *Georday Enterprises* v. *Commissioner,* 126 F. 2d 384 (C. C. A. 4th). Yet taxpayer in no way justifies this legerdemain. Some writers (1 Mertens, Law of Federal Income Taxation, Sec. 9.58) and courts (*Campbell* v. *United States,* 144 F. 2d 177 (C. C. A. 3d)), are of opinion that the general principle of inherited earnings or profits does not always apply whenever there is a non-taxable reorganization and that the test should not merely be the tax-free character of the so-called reorganization, but whether in addition there is substantial identity of the several corporations and continuity of the proprietary interest. Even subscribing to this limitation on the *Sansome* doctrine, it in no way precludes the application of the rule here. For the parent has completely taken over the subsidiary. There is complete identity of the corporations and the same share-

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[9] See fn. 12, *infra.*

[10] See fn. 3, *supra.*

[11] H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41–42. S. Rep. No. 2114, 76th Cong., 3d Sess., p. 25.

holders of the parent who in effect owned the subsidiary and the parent as separate corporations now own the parent embodied with the subsidiary. In fact, as pointed out by the Tax Court and contrary to taxpayer's interpretation (Br. 34–36), the Circuit Court in *Helvering* v. *Credit Alliance Corp.*, 122 F. 2d 361 (C. C. A. 4th), had no doubt that the earnings or profits of a subsidiary corporation, liquidated under Section 112 (b) (6) of the Revenue Act of 1936, retained their character as such in the hands of the parent in accordance with the *Sansome* rule. It there said (p. 365):

> This principle [*Sansome*], however, does not necessarily lead to the Commissioner's conclusion [that no dividend credit may be had for a tax-free liquidation distribution]. It is obvious that Congress may have used the term "earnings or profits" in Section 27 (f) in its customary sense, so as to provide that a distribution thereof in liquidation, as distinguished from a distribution of capital, should give rise to a dividends paid credit, and at the same time have provided in Section 112 (b) (6) that no gain or loss should be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. Indeed these sections read together adhere to the principle of *Commissioner* v. *Sansome, supra,* for they recognize that the property distributed remains in substantially the same hands and that no actual gain or loss has been realized in the transaction. Furthermore, if this interpretation is given, an obstacle to the

simplification of corporate structures desired by Congress is removed.

We think that the term "earnings or profits" was used in Section 27 (f) to exclude from its purview a distribution of capital. We are of opinion, also, that the treatment of the distribution in this case as a taxable dividend paid will not conflict with the purpose of Congress to impose a surtax upon undistributed corporate profits. It is true that a distribution of the property will relieve the taxpayer, the subsidiary corporation, from the payment of an undistributed profits tax, and the receipt of the property by the parent corporation will not require the imposition of a tax upon it for a gain received; but it is not true that the distributee will be under no liability for an undistributed profits tax upon the profit received if it remains undistributed in its hands. The distributor, having distributed the property, is free from the undistributed profits tax; the distributee having received that which in another capacity it already possessed, is not required to pay a tax upon its formal receipt; but there is nothing in the Act which says that the distributee is not subject to a tax upon undistributed profits if it persists in the retention of property which, in its hands as in the hands of the former holder, retains its character as undivided profits. This interpretation has the undoubted advantage, that it gives to Sections 27 (f) and 27 (h) their normal meaning, and at the same time gives effect to the underlying purposes of the Act to tax undistributed corporate profits and also to facilitate

and encourage the simplification of corporate structures.

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The application of the *Sansome* doctrine to a tax-free liquidation under Section 112 (b) (6) of the Revenue Act of 1936, was thought to apply regardless of the non-applicability of the 1938 amendment adding "or property or money" to tax-free distributions which were not to be considered as distributions of earnings or profits. It is not at all inconsistent that for purposes of a dividend credit, which is a matter of legislative grace, liquidation distributions of property are treated as taxable dividends paid of amounts properly charged to earnings or profits, yet because no tax is due from the distributee corporation, the earnings or profits remain unchanged in its hands. The *Credit Alliance* case was only concerned with the problem of the credit to be given in determining the 1936 surtax liability, where in 1938 the Congress expressly said that tax-free distributions of property did not diminish earnings or profits. Although the case held that this latter expressed intent could not affect the interpretation of Section 27 (f) of the 1936 Act, it did not hold that the parent did not retain the earnings of the subsidiary and that the earnings simply vanished after the transaction.

And we fail to see the magic as does taxpayer (Br. 15–17) in the isolated liquidation of a corporation. The series of cases applying the *Sansome* doctrine involve many where the transferor corporation has been liquidated in connection with a reorganization.

The reorganization aspect merely makes the transaction tax free. It does not change the bald fact that one company is liquidated and another takes over its assets, earnings and profits. *Baker* v. *Commissioner,* 80 F. 2d 813 (C. C. A. 2d), is a good example of this. There, X corporation owned all the stock of A, B, C, D, and E corporations. X then formed Y corporation and exchanged A, B, C, D, and E stock for Y stock. At this moment Y is the parent owning all the stock of A, B, C, D, and E—the same as Metropolitan was the sole shareholder of Cole-French. Y then took over all the assets and assumed all the liabilities of A, B, C, D, and E in exchange for their stock. This was in effect the liquidation of subsidiaries into the parent. When Y made a distribution to X (comparable to Metropolitan's distribution to taxpayer) the distribution was from its earnings or profits derived from A, B, C, D, and E. Thus the fact the subsidiary is liquidated rather than merged or consolidated has nothing to do with the rationale of *Sansome.* In the last analysis the same individual shareholders receive the distribution whether the transaction takes the form of an isolated liquidation or one connected with a reorganization.

Taxpayer's argument for a distinction seems to be based upon a misconception of the mechanics of the reorganization and basis sections of the Revenue Acts. It is argued (Br. 15–16) that in the case of the transfer of assets in a reorganization the predecessor or transferor corporation realizes a gain or loss which is unrecognized, whereas in a liquidation the liquidated corporation does not. Not only does this

seem irrelevant, but we submit it is not correct. It is not because the transferor corporation realizes a gain or loss in the transaction that the *Sansome* rule applies. This can be shown by the following illustration:

If A corporation has original assets with a basis of $100,000 and accumulated earnings or profits of $100,000 invested in other assets, an exchange for $200,000 or stock of a newly formed corporation even if recognized, results in no gain to A. A realized gain when it made its profits. And if the exchange is in connection with a tax-free reorganization, the distributee corporation still takes, under *Sansome,* the property of A with its $100,000 of earnings or profits despite the fact A corporation realized no gain on the exchange. Taxpayer apparently is confusing the situation where there is an appreciation in value of assets which has been held to result in earnings or profits to the transferor even though the assets were disposed of in a tax-free exchange. See *F. J. Young Corp.* v. *Commissioner, supra.* This being so, taxpayer is also in error (Br. 17–21) in assuming that Section 113 (a) (15) which gives the transferee the transferor's basis in a Section 112 (b) (6) liquidation results in double earnings or profits if the rule in the *Sansome* case also applies. Assume A corporation has original assets with a basis of $100,000 and earnings or profits of $100,000 invested in other assets. The basis of all its property is $200,000. If A is then liquidated by its parent corporation, B, under Section 112 (b) (6), Section 113 (a) (15) also applies and B gets A's basis of $200,000.

On a subsequent sale of all the property for $200,000 B realizes no gain. But the earnings or profits of $100,000 retain their character in B's hands under *Sansome.* There is thus no discrimination (Pet. Br. 21) against corporations receiving property in complete liquidation of subsidiaries. In truth, were taxpayer's contention sound such corporations would be given preferred treatment since the mere fact of liquidation would transmute the earnings to capital and remove them forever from being the source of future dividend distributions. Nor can the liquidation be distinguished on the ground (Pet. Br. 19) that the shareholders are never taxable upon earnings or profits of the liquidated corporation upon their distribution in liquidation. Whether they are or are not does not seem to us important, but it should be noted that Sansome himself was taxed on dividends allocated to earnings or profits in the liquidation distribution under Section 201 of the 1921 Act.

Since there are no essential differences between an isolated corporate liquidation of a subsidiary corporation and one connected with a reorganization, Congress could never have intended, as taxpayer suggests (Br. 29), to have limited the application of the *Sansome* rule in enacting Section 115 (h) of the Revenue Act of 1936. The Senate committee report [12] shows

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[12] S. Rep. No. 2156, 74th Cong., 2d Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 678, 690) states:

"Sec. 115 (h). *Effect of distributions on earnings and profits.*

"The rule, under existing law, with respect to the effect on corporate earnings or profits of a distribution which, under the applicable tax law, is a nontaxable stock dividend or a distribution of stock or securities in connection with a reorganization or other

that Congress believed that Section 115 (h) of the Revenue Act of 1934 and corresponding provisions of prior acts stated the doctrine only in part, and in the interest of greater clarity wished to express in the statute the rules applied by the Treasury and supported by the courts. The *Sansome* rule since its pronouncement in 1932 had been applied to supplement statutory provisions not as broad as Section 115 (h) of the Revenue Act of 1936. Since it always would have been applied to the type of situation involved in the instant case it surely should not be restricted because of the enactment of statutory provisions intended to give express legislative approval to the doctrine.

However interesting these ramifications of the problem are, they are not apposite to the decision in the case. Section 115 (h) of the Internal Revenue Code applies and expressly covers the situation. The distribution in 1939 by Metropolitan to taxpayer was from its earnings or profits which were inherited at

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exchange, on which gain is not recognized in full, is that such earnings or profits are not diminished by such distribution. In such cases, earnings or profits remain intact and hence available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. This rule is stated only in part in Section 115 (h) of the Revenue Act of 1934, and corresponding provisions of prior Acts, but is the rule which is applied by the Treasury and supported by the courts in *Commissioner* v. *Sansome* (60 Fed. (2d) 931: *United States* v. *Kauffman* (62 Fed. (2d) 1045): *Murcheson* v. *Comm.* (76 Fed. (2d) 641). While making no change in the rule as applied under existing law, the recommended amendment is desirable in the interest of greater clarity."

the liquidation of Cole-French under Section 112 (b) (6) of the Revenue Act of 1936.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted.

SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
ROBERT N. ANDERSON,
LEONARD SARNER,
Special Assistants to the Attorney General.

JANUARY 1945.

Argued by Mrs. Paul.

APPENDIX

Revenue Act of 1936, c. 590, 49 Stat. 1648:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) *Exchanges Solely in Kind.*—

* * * * *

(6) *Property Received by Corporation on Complete Liquidation of Another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(15) *Property Received by a Corporation on Complete Liquidation of Another.*—If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112 (b) (6), then the basis shall be the same as it would be in the hands of the transferor.

Internal Revenue Code:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earn-

ings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

*   *   *   *   *

(h) *Effect on Earnings and Profits of Distribution of stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation.—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under Section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes right to acquire stock or securities.

*   *   *   *   *

(26 U. S. C. 1940 ed., Sec. 115.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

Sec. 19.115–11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made

(including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1939, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1939, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in section 112 (b) (6)

of the Revenue Act of 1936, or of the Revenue Act of 1938, or of the Internal Revenue Code.

(3) The distribution in any taxable year (beginning after December 31, 1938) of stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act. A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

For the purposes of this section, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning

before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934; for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936; and for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938.

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